ERISA FIDUCIARY CONSIDERATIONS WHEN INCORPORATING ALTERNATIVE INVESTMENTS IN YOUR PENSION PLAN’S PORTFOLIO

By José M. Jara

A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior... the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd.

Judge Benjamin N. Cardozo

Introduction

Fiduciary duties are the highest duties known to law. As a fiduciary of a pension fund careful and prudent consideration must be made of the investments in the plan’s portfolio. Of late alternative investments have become an increasingly popular investment for pension plans. Recently the U.S. Department of Labor, Employee Benefits Security Administration (DOL) has been under the microscope by its own Office of Inspector General for failing to properly investigate plans that invest in alternative investments. A report to Congress from the Office of Inspector General identified significant concerns about the nearly $3 trillion of alternative investments held by employee benefit plans and the need for the DOL to do more to ensure that plan administrators properly identify and value those hard-to-value investments. Plan administrators and trustees should have a process for periodically reviewing all plan investment options, but alternative investments in the trust merit particular attention.

What are alternative investments?

Commonly held investments in pension plans are traditional stocks and bonds, whether owned directly as individual securities or indirectly as mutual funds. These traditional investments include securities originating both in the U.S. and abroad. Alternative investments can be defined in its broadest terms as investments that include anything that does not fall into the categories above. They vary widely in structure, strategy and risk profile. Examples include hedge funds, private equity funds, real estate, commodities and infrastructure.

The strategy behind some alternatives, like real estate, commodities and infrastructure, are obvious. These alternatives invest in tangible goods that are not typically available to smaller investors due to barriers to entry like high costs or increased expertise. A small investor cannot

afford to own commercial real estate or a toll road, nor will they necessarily understand the intricacies of the corn futures market.

Private equity funds also package a familiar investment, ownership interest in a company. Unlike readily tradeable public equities, private equity cannot be found on any exchanges. Access and liquidity, therefore, become the barriers to entry. However, the carrot of a public offering can provide great value.

The most ubiquitous alternatives are hedge funds, but also are the most difficult to understand, in part due to the wide variety among funds. Hedge funds began as funds designed to produce returns without the market exposure of traditional investments, "hedging" against poor performance in public equities and fixed income. The funds used tools like leverage, short-selling and derivatives achieve these goals. Hedge funds have evolved to use a wide variety of strategies and do not always create a "hedge" in the traditional sense. While widely available mutual funds can now make use of some of the speculative tools used by hedge funds, the lesser regulated hedge funds retain some advantages, especially in their ability to use leverage.

**ERISA and Plan Fiduciaries**

Complying with the Employee Retirement Income Security Act of 1974 ("ERISA") is no easy task given the complexity of the statute and the fact that the law continues to develop at a rapid pace as a result of a number of factors. A fiduciary’s task is made that much more difficult given that the issue of whether a person has breached his or her fiduciary duties is extremely fact-intensive and may vary depending on the particular Circuit within which a lawsuit is brought. It is thus often difficult to predict whether a particular course of action will shield the fiduciary from liability or make the fiduciary an easy target for the government or plaintiff’s bar.

It is important to determine who are plan’s fiduciaries. A person is an ERISA “fiduciary”:

[w]ith respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan ... .

**ERISA Prudence and Diversification**

ERISA requires that fiduciaries (i) act for the “exclusive purpose” of the plan, (ii) act with “prudence,” (iii) “diversify” plan investments, and (iv) act in accordance with the “terms of the plan.”

An ERISA fiduciary is required to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims. Courts have interpreted the prudence requirement with the “prudent expert” standard – i.e., the fiduciary must act “as a prudent investment manager under the modern portfolio theory [MPT].”²

While no one can predict exactly which investments will out-perform other investments, or which decision is the best decision, prudence requirements may be met by a process that requires investments to be examined for appropriate factors such as the risk of loss, the opportunity for return, diversification, liquidity, current return and projected return.

Under the MPT, fiduciaries are required to give appropriate consideration of all relevant or material attributes of an investment, as well as the surrounding facts and circumstances. An investment that is reasonably designed as part of an overall plan portfolio to further the purposes and objectives of a plan should not be deemed to be imprudent because the investment, standing alone, would have a relatively high degree of risk. However, this does not mean simply that a plan investment should be deemed prudent solely by reason of the aggregate risk and return characteristics of the plan’s portfolio. Rather, a fiduciary must give “appropriate consideration” to those facts and circumstances that the fiduciary knows or should know are relevant to the investment involved, including the role the investment plays in the plan’s investment portfolio.

DOL guidance states that appropriate consideration or alternatively, procedural due diligence, means ensuring investment decisions are reasonable, and applicable to the plan’s design:

> Appropriate consideration shall include, but is not necessarily limited to, (i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action.³

Further DOL guidance suggests that fiduciaries adopt core MPT principles relating to recommended portfolio diversification and quantitative risk management. Fiduciaries should give ample consideration to the following factors:

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² DiFelice v. US Airways, Inc., 497 F.3d 410, 423 (4th Cir. 2007).
³ 29 C.F.R. 2550.404a-1.
(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan.\(^4\)

A common theme of alternative investments is less liquidity than traditional stocks and bonds. Public equity and fixed income can be traded on a daily basis as public markets connect buyers and sellers. The same cannot be said of alternatives. Hedge funds often only provide liquidity on a quarterly or longer basis. Private equity typically ties up funds for years and the high transaction costs associated with real estate means that properties change hands very infrequently. This illiquidity makes it difficult for many investors to utilize alternatives. However, this is not issue for pension plans. Many scheduled pension payments will not occur until years or decades from now. Liquidity is not a necessity for the investments backing such payments. Plans can therefore utilize alternatives for their diversifying properties and also take advantage of a liquidity premium, the additional return they receive in exchange for locking up the funds for long periods of time.

Alternatives hold many appealing properties for pension plans but there are downsides as well. The lack of liquidity should not become an issue when the associated pension payments are far in the future but liquidity is needed when the monies eventually come due. The lack of liquidity can also lead to a lack of transparency (the underlying investments are not necessarily disclosed on a frequent basis) and difficulties in pricing (since they are not traded frequently on the open market to establish a fair value). Some alternatives, like hedge funds, are subject to less scrutiny from regulators and those pose additional risks in terms of governance.

ERISA also requires that a fiduciary diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.\(^5\) ERISA does not establish actual percentage limits for plan investments. In determining whether assets are diversified, fiduciaries should examine factors such as: (i) the amount of plan assets; (ii) the cash flow needs of the plan; and (iii) the composition of the plan’s investment portfolio as a whole.

Since alternatives fall outside of the traditional investment categories, they typically have relatively low correlation to public equities and fixed income. With this lower correlation lies the appeal of alternatives. Adding an alternative investment helps diversify a plan's portfolio. Harry Markowitz, the Nobel Prize-winning economist, famously called diversification the only free lunch in investing. Simply constructing a portfolio of assets with low correlation will lead to less risk than a portfolio made up solely of highly correlated securities, without necessarily impacting the level of return. It may even increase the level of return. Highly correlated assets

\(^4\) 29 C.F.R. § 2550.404a-1(b)(2).

move together, both up and down, not always to the same extend but typically in the same direction. Uncorrelated assets will move in opposite directions, ensuring that the entire portfolio does not suffer steep losses all at once, providing an opportunity to rebalance, selling high and buying low. Adding even a single investment with low correlation to a portfolio can have a positive impact.

Historically, plans looking to increase diversification often begin by looking overseas. However, increased globalization means that foreign public equities, from developed nations and even emerging markets, no longer add the same level of diversification. Thus, plan sponsors increasingly look to alternatives to provide this benefit. Another benefit of alternatives that invest in “real” assets is their ability to keep up with inflation.

Fiduciaries should review the investment policy statement (“IPS”) and guidelines to reflect alternative investments as well as the current economic conditions. The DOL has encouraged plan fiduciaries to adopt written statements of investment policy and stated that compliance with ERISA’s prudence requirement requires maintenance of proper documentation of the activities of the investment manager and of the named fiduciaries of the plan in monitoring the investment manager.

**Fees and Expenses**

Alternatives often charge high fees. Plan sponsors must first determine the full cost of an investment and, then determine whether such fees are justified. In considering the fees being charged, plan sponsors must obtain sufficient investment information. With the recent and heightened focus on the reasonableness of the fees paid under a contract or arrangement, fiduciaries should (i) review all existing contracts and arrangements to ensure that they are in compliance with the requirements of ERISA. If the contract or arrangement does not qualify under an ERISA exemption, the plan fiduciary who participated in the arrangement could be deemed to violate the prohibited transaction rules of ERISA and the service provider could be deemed a disqualified person under the internal revenue code and be subject to excise taxes.

Further, the high fees should also be considered when establishing the alternatives allocation in an IPS. Investment fees should be considered on a plan-wide basis. Relatively high fees on a small alternative allocation combined with the lower fees of traditional investments may result an appropriate risk/net return profile, while an all-alternative portfolio may result in prohibitive fees.

*Should a cap be implemented in terms of the plan’s percentage of assets that are invested in alternatives?*

In short, yes but the amount depends on the plan’s situation. Alternatives often come with limits on liquidity. Plans need to keep enough funds in liquid investments to make benefit payments over the next three to five years. ERISA also establishes certain liquidity requirements that should kept in mind. Plans that pay lump sums or that plan to terminate in the near future should be even more cautious about holding illiquid alternatives.
Alternatives often provide diversification benefits by protecting against the downside. In other words, alternatives may sacrifice some of the upside of traditional investments, like public equities, in order to eliminate some potential losses. Such protection can be valuable for a well-funded plan but the plan sponsor of a poorly funded plan may determine that higher returns and, thus, higher risk are more appropriate. In such a case, a plan sponsor may look to limit the use of alternatives.

_A word on tax strategy_

Tax-exempt investors such as pension plans are subject to unrelated business taxable income (“UBTI”). Passive investment income (e.g., interest, dividends, royalties) received by a pension plan is generally not subject to UBTI. Nonetheless, a pension plan may be subject to UBTI if it is: (1) engaged in a trade or business unrelated to its tax-exempt purpose or (2) engaged in debt-financing which produces income (also known as unrelated debt-financed income or UDFI).

Many pension plans will want to block UBTI or UDFI, but may not have the internal tax expertise to do so. They will not be interested in filing a US Form 990-T or a state equivalent return. Pension plans can set up an intermediary corporation to block UBTI or UDFI. If the corporation is incorporated in the US, the pension plan can suffer thirty five (35) percent tax leakage, which will reduce the return on investment. On the other hand, if the intermediary corporation is an off-shore tax haven entity which does not tax corporate income, there will be no tax leakage unless some of the tax withholding exceptions apply, which could cause substantially more tax leakage than if the tax-exempt entity pays tax on the UBTI or UDFI that has been generated.

Depending on the life cycle of the investment, structuring the method of investment can save the pension plan somewhere in the neighborhood of several hundred thousands to millions of dollars in tax leakage.

_Conclusion_

Fiduciaries of a pension plan should understand all the investments in the pension plan’s portfolio. Alternatives are significantly more complex than traditional investments and if not fully understood can do more harm than good to a plan’s portfolio. Plan sponsors should identify objectives and find alternatives that fit their needs. Simply pouring funds into alternatives without a strategy can result in worse outcomes.

After taking all the above items into consideration, plan sponsors should set a firm upper limit on alternatives in their IPS. In addition, plan sponsors should also consider lowering this limit as the plan becomes better funded and termination approaches.

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